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No. 384

In the Supreme Court of the United States

OCTOBER TERM, 1949

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHRISTIAN W. KORELL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 9–14) are reported at 10 T. C. 1001. The opinion of the Court of Appeals (R. 16–21) is reported at 176 F. 2d 152.

JURISDICTION

The judgment of the Court of Appeals was entered June 8, 1949 (R. 21). A petition for rehearing was denied on July 14, 1949 (R. 33). The petition for a writ of certiorari was filed on October 11, 1949, and the writ was granted on December 5, 1949 (R. 34). The jurisdiction of this Court rests upon 28 U. S. C. Section 1254.

QUESTION PRESENTED

In August 1944, taxpayer purchased callable 3% debenture bonds, of $100 face value, at slightly over $121; the bonds were then callable by the debtor at $104; they were also immediately convertible (at the holder's ~~opinion~~ option) into the debtor's stock, which was selling at about $163, on surrender of $100 face value plus $40 in cash. On these facts, the Tax Court and the Court of Appeals recognized that the excess over the call price was not paid because of high interest returnable on the bonds but represented consideration paid for the valuable privilege of converting the bonds to the debtor's stock at a rate below the then market price of the stock.

The question presented is whether the taxpayer is nevertheless entitled, under Sections 23 (v) and 125 of the Internal Revenue Code, to an "amortizable bond premium" deduction from gross income for the taxable year 1944, measured by the difference between the cost of the bonds ($121) and the call price ($104).

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra*, pp. 31–39.

STATEMENT

The facts, as stipulated (R. 2–9) and as found (R. 9–10), may be summarized as follows:

Taxpayer, an individual, filed his income tax return for the period in question with the Col-

lector of Internal Revenue for the Second District of New York. (R. 9.)

During 1944 taxpayer purchased $50,000 principal amount of American Telephone and Telegraph Company 15-year 3% convertible debenture bonds, due September 1, 1956, as follows (R. 9):

Purchase Date	Face Value		Unit Price	Amount Paid
August 16, 1944	$11,000	at	121¼	$13,351.25
August 16, 1944	$ 2,000	at	121	2,425.00
August 22, 1944	$37,000	at	121¼	44,862.50
Totals	$50,000			$60,638.75

The average market price of the capital stock of the American Telephone and Telegraph Company on August 16, 1944, was $163.1875 per share, and on August 22, 1944, was $163.6875 per share. (R. 9.)

These bonds were issued under an indenture between American Telephone and Telegraph Company and City Bank Farmers Trust Company, trustee, dated September 1, 1941.[1] The indenture provided in part (Section 3.01 (R. 4)) that on not less than thirty days' notice the bonds might be redeemed by the company in whole or in part on any date on or after September 1, 1942, "at the following redemption prices (expressed in percentages of the principal amount) together with accrued interest to the date fixed for re-

[1] A copy of the indenture dated September 1, 1941, was attached as an exhibit to the stipulation of facts. Only the material provisions are printed in the Record. The full indenture has been filed with the Court.

demption: to and including August 31, 1944, 107%; thereafter to and including August 31, 1948, 104%; thereafter to and including August 31, 1953, 102%; and thereafter, 100%." (R. 9–10.)

The indenture further provided (Section 4.01 (R. 4–5)) that the holder of any debenture bond "shall have the right, at his option, at any time after January 1, 1942, to and including December 31, 1954 (except that, in case any Debenture Bond or Debenture Bonds shall be called for redemption before such latter date and payment thereof duly provided for, such right shall terminate at the close of business on the date fixed for redemption of such Debenture Bond or Debenture Bonds), to convert * * * the principal of any such Debenture Bond * * * into such number of full-paid and nonassessable shares of Capital Stock of the Company as the principal amount of the Debenture Bond * * * surrendered for conversion is a multiple of $100 * * * at the price of $140 per share * * *," by the surrender of $100 principal amount of debenture bonds and payment to the company of cash equal in amount to the excess of the conversion price over $100. (R. 10.)

The entire issue of these bonds was called for payment under the provisions of the indenture as of September 1, 1947, at 104, plus interest. (R. 10.) The record does not indicate how and when

the bonds purchased by the taxpayer were disposed of.[2]

In his return for the taxable year (1944) taxpayer claimed as a deduction, in computing net income, "amortization" of the premium paid with respect to his bonds in the amount of $8,638.75, representing the full difference between $60,638.75—the cost of the bonds—and $52,000—the call price of the bonds, at 104. (R. 10.)[3]

The Commissioner disallowed the deduction, having ruled that the difference between the cost and the call price was not "amortizable bond premium," within the meaning of the statutory provisions. The Tax Court concluded that the Commissioner had erred and this conclusion was sustained by the Court of Appeals. (R. 9–15, 16–21.) Subsequent to the determination of the

[2] These American Telephone and Telegraph Company bonds purchased by the taxpayer were not part of his stock in trade, or includible in any inventory of the taxpayer at the close of the taxable year, held by him primarily for sale to customers in the ordinary course of his trade or business, but were purchased by him as an investment. The taxpayer did not, during the calendar year 1944, sell any of the above bonds purchased by him, nor did he exercise his privilege of converting them into capital stock of the company (R. 10). These debentures were the only premium bonds purchased or owned by him in the year 1944 (R. 10).

[3] Taxpayer considered the call price of the bonds to be the price at which they could have been called if the debtor had given a call notice on the dates of purchase; under the indenture, this was $104. *Supra*, pp. 3–4. If taxpayer is entitled to the deduction, petitioner does not dispute this method of computation (R. 20).

appellate court here, the Court of Appeals for the Ninth Circuit had occasion to consider precisely the same question—involving the same issue of A. T. and T. bonds—and reached a conclusion contrary to that reached in this case. *Commissioner* v. *Shoong*, 177 F. 2d 131 (pending on petition for a writ of certiorari, No. 453, this Term).

SPECIFICATION OF ERROR TO BE HELD

The Court of Appeals erred in holding that the difference between the cost and the call price of the debentures here was deductible in full in 1944 as "amortizable bond premium" within the meaning of the statutory provisions.

SUMMARY OF ARGUMENT

The legislative history of Section 125 of the Internal Revenue Code conclusively demonstrates that where the excess price over the call price of bonds or debentures is paid for the privilege of converting the debentures to capital stock at a rate below the market price of the stock, the difference between cost and call price is not "amortizable bond premium." The purpose of the Treasury in proposing the legislation, and of Congress in enacting it, was to provide for the amortization out of interest earnings of that portion of the interest which was in reality return of premium; and "amortizable bond premium" is that extra price which is paid to obtain an above-average interest yield and which is thus reflected in each interest distribution. Where a

true premium is paid, the value of the bonds will diminish by the mere passage of time, and Congress considered it sounder accounting practice to amortize out of interest earnings that part of the interest which was really premium, as a substitute for the prior procedure of taking a loss on disposition.

Here, no part of the so-called premium was paid to obtain a high interest rate; the interest was all true interest and did not reflect or include premium to any extent, and there was nothing to recover out of interest earnings. Moreover, since the taxpayer was in a position to recover the excess price paid by exercising the option to convert the bonds to stock, or simply by selling the bonds which reflected the conversion value, there was no loss to recover by amortization. In concluding that the difference between the cost and the call price of these debentures was nevertheless "amortizable bond premium," the Court of Appeals failed to give effect to the plain purpose of Congress in granting the deduction. The result was a conclusion wholly unwarranted by, and, indeed, squarely in the teeth of the legislative intention. The result is also a wholly gratuitous deduction, permitting the taxpayer to reap a windfall.

There is no support, moreover, for the court's decision in the statute's language. In Section 125, Congress did not establish a special definition of "amortizable bond premium," or equate

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it with every excess over call price or maturity value, and the meaning of the term must be gathered from the legislative purpose and aim, as well as from the common understanding of the words "bond premium."

ARGUMENT

The price paid in excess of the call price of the debentures involved was not "amortizable bond premium" within the meaning of sections 23 (v) and 125 of the Internal Revenue Code

Introductory

The single issue presented is whether the taxpayer is entitled, under Section 23 (v) and 125 of the Internal Revenue Code (Appendix, *infra*, pp. 31–34), to deduct in a lump sum as "amortizable bond premium" the full difference between the cost and the call price of certain 15-year 3% convertible debenture bonds of the American Telephone and Telegraph Company. The bonds were purchased in August of 1944 at the approximate price of $121 per bond, were callable at prices ranging from $104 to $100 depending on the call date,[4] and carried with them the privilege of conversion to the capital stock of the issuing company on the basis of one $100 bond plus $40 in cash for each share of capital stock. (R. 2–3, 9–10.) The average price of the capital stock at the time of the bond purchases was $163 a share. (R. 9.) The approximate sum of $17 per bond paid in excess of the actual call

[4] In August 1944, the call price was $104. *Supra*, p. 4.

price was thus plainly paid for the privilege of purchasing the stock at approximately $20 below the market price, rather than for the interest returnable on the bonds, and both the Tax Court and the Court of Appeals so recognized (R. 13, 18, 19). Nevertheless, each court held that the excess could be treated as "amortizable bond premium" under the provisions of Sections 23 (v) and 125, which were enacted into law in the Revenue Act of 1942, c. 619, 56 Stat. 798.

Basically, the question before the Court is whether this 1942 change in the Internal Revenue Code should be construed so as to permit the outright purchase of a tax deduction. While the Court of Appeals here concluded that Section 125 does embrace an apparently clear-cut tax windfall device, the Court of Appeals for the Ninth Circuit in *Commissioner* v. *Shoong*, 177 F. 2d 131, pending on petition for a writ of certiorari, No. 453, determined that the statutory provisions were not intended by Congress to be "construed as to produce this unreasonable result." The holding of the Court of Appeals for the Second Circuit to the effect that any amount paid in excess of the call price of convertible bonds is deductible under Section 125 as "amortizable bond premium" even though paid for the privilege of converting the bonds to stock at a rate below the market price of the stock, if permitted to stand, will constitute an open invitation to

taxpayers to shift income at will and to extinguish tax liability.

The nature of the legal problem and the workings of the tax scheme are perhaps best illustrated by reference to the parallel facts in the somewhat fuller record in *Commissioner* v. *Shoong, supra.* In June of 1944, Joe and Rose Shoong purchased over $1,000,000 worth of the same issue of A. T. and T. 15-year 3% convertible debenture bonds. Although each bond was callable at $104, the Shoongs also paid approximately $120 for each bond, for the same reason that the bonds carried with them the privilege of conversion to the capital stock of A. T. and T. at a rate of approximately $20 below the then price of the stock. Upon the purchase of the bonds, the taxpayers, like respondent here, claimed the entire difference between the cost and the call price of the bonds as an ordinary deduction under Sections 125 and 23 (v); the deduction was claimed in a single year since the bonds were callable after thirty-days' notice. The resulting deductions claimed by the Shoongs practically extinguished their 1944 income tax liability.[5] In accordance with

[5] Joe Shoong reported adjusted gross income of $104,304.58, and deductions of $97,533.76, of which $81,879.95 represented a claim for "amortization" of bond premium on the A. T. and T. bonds. The net income reported was $6,770.82 (No. 453, R. 21, 62).

Rose Shoong reported adjusted gross income of $100,927.43, and deductions of $96,235.34, of which $85,607.29 represented a claim for amortization of bond premium on the

their preconceived plan they held the bonds for slightly over six months and disposed of them in January of 1945, treating the difference between the adjusted basis and the selling price, which, of course, still reflected the conversion value, as capital gain—only half of which had to be taken into account for tax purposes.[6] *Shoong* v. *Commissioner, supra,* No. 453. (No. 453, R. 21–23, 30.) In short, the Shoongs purchased a tax windfall readily available to others on the open market by following a procedure considered by the Court of Appeals below to have been sanctified by Section 125.

In the Commissioner's view, the Second Circuit's determination "would permit the schemes of taxpayers to supersede the legislation in the determination of the time and manner of taxation." *Higgins* v. *Smith,* 308 U. S. 473, 477–478. Had the Court of Appeals devoted itself to the question as to "whether what was done, apart from the tax motive, was the thing which the statute intended" (*Gregory* v. *Helvering,* 293 U. S. 465, 469), giving proper effect to the legislative history, a contrary conclusion would have been

A. T. and T. bonds. The net income reported was $4,691.59 (No. 453, R. 22, 62).

[6] The adjusted basis took account of the 1944 deduction of amortizable bond premium. But the adjustment was reflected only to the extent of one-half in the computation of the Shoong's 1945 taxes, since it was taken into account only in the computation of capital gain on sale, whereas the 1944 deduction was measured by the full amount of the premium.

reached; for an analysis of the reasons leading to the enactment of the statutory provisions involved, and of their legislative history, conclusively demonstrates that the difference between the cost and the call price of these A. T. and T. debentures was not "amortizable bond premium."

A. *The legislative history and purpose of the Code provisions prove that only true bond premium can be amortized and deducted.*—In the 1942 amendment involved here, Congress did not permit the deduction or amortization of every excess over the call price or maturity value of a bond or debenture. As Congress was dealing with a "bond premium," that term does not encompass every payment over the call price or maturity value made in connection with the purchase of a bond, regardless of the purpose of the payment. Bond premium simply represents the excess capital paid by the purchaser in order to obtain a higher rate of interest than the current rate for comparable obligations. Neither in the mind of Congress nor in the common understanding of laymen is it a payment manifestly made for what is in essence a valuable option to purchase stock, or for some other privilege unrelated to the interest yield of the security.

That this was the meaning intended by Congress is undeniably proved by the Report of the House Ways and Means Committee (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 47 (1942–2 Cum. Bull. 372, 410) setting forth the reason for

the proposed deduction of "amortizable bond premium" as follows:

> Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance.
>
> The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. *Holders of taxable bonds not only pay a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital "lost" at maturity.* Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it. [Italics ours.]

This Committee Report indicates that, in the eyes of Congress, bond premium is that capital which has been paid to obtain a higher rate of interest than the average market yield, and which is thus included as a portion of each of the interest pay-

ments made on the bond. As the Report points out, prior to 1942 these interest payments were treated fully as income, amortization of the premium out of the interest earnings was not permitted, and the bondholder could take account of the premium, taxwise, only as a loss suffered at the time of call or of ultimate disposition of the obligation. See *New York Ins. Co.* v. *Edwards*, 271 U. S. 109, 116; O. D. 475, 2 Cum. Bull. 211; *Corn Exchange Bank* v. *Commissioner*, 6 B. T. A. 158. The purpose of the new deduction was to change this method of handling the premium, and to allow the taxpayer to recover out of the interest earnings that portion of the purported interest which was really capital or premium. In this connection, it is significant that in the *New York Ins. Co.* case the taxpayer made the following contention (pp. 112–113):

> Securities sell at a premium because they are sound and pay a high interest return. A part of the high interest return must be put aside each year to reimburse for the premium paid, that is, for the yearly loss of the premium. But the entire interest was taxed as income. Hence, if the part of the interest used to reimburse for the yearly loss of premium is deducted, then by the deduction only that part of the interest is taxed which was in fact interest income.

The rejection, under the then existing statute, of the contention made by the taxpayer there led

ultimately to the enactment of Section 125, which, as the Committee Report proves, incorporates into the law the concept that where a bond is issued at a true premium, the premium is paid to obtain a higher rate of interest, with the consequence that each interest distribution reflects in part a return of capital which should not be taxed as income.

That Congress used the term "amortizable bond premium" in this sense, and only in this sense, is further shown by the testimony of Randolph Paul, in his capacity as Tax Advisor to the Secretary of the Treasury, given before the House Ways and Means Committee. In explaining the nature of the deduction contemplated and the reason for granting it, Mr. Paul stated (1 House Hearings on the Revenue Act of 1942, p. 90):

> (d) *Amortization of bond premium.*—Holders of a tax-exempt security purchased at a premium are today in the unique position of being relieved of tax on the interest paid on the security and of receiving a deductible loss upon redemption or other disposition of the security to the extent of the premium. As *the premium at which a bond is obtained represents to the holder* merely an *effective yield lower than the actual interest rate*, the holder is entitled merely to tax exemption solely with respect to such effective yield. *The difference between the yield and the actual interest rate is simply a return of*

capital and should be treated as such rather than as a capital loss. On the other hand, the holder of a taxable security purchased at a premium is in the unfortunate position of being taxed upon the interest at high rates and of receiving a capital loss upon redemption whose deductibility is subject to the restrictions placed upon capital losses. *Since the yield rather than the actual interest rate reflects the true income to the taxpayer, only that income should be subject to tax and the capital loss should disappear.*

Proper tax treatment in both situations may be obtained through amortization of the premium. It is suggested that such amortization be mandatory for wholly tax-exempt securities and for partially tax-exempt securities held by a corporation. For all other securities the amortization should be at the taxpayer's election. [Italics supplied.]

As Mr. Paul points out, the premium represents the amount paid to obtain an interest rate in excess of the true average yield, and the purpose of Section 125 was to allow the taxpayer to deduct the difference between the true average yield and the actual interest rate, which was simply a return of capital, or premium.

The purpose of the deduction and the meaning of "amortizable bond premium" were also vividly explained by the testimony of John O'Brien of the Office of the Legislative Counsel before the

Senate Finance Committee. With regard to "amortizable bond premium" Mr. O'Brien testified as follows (1 Hearings Before the Committee on Finance, 77th Cong., 2d Sess., on H. R. 7378, p. 52):

> It deals with the case in which a bond is purchased, let us say, for $100 and upon redemption the taxpayer gets $90; or—Well, put it the other way: The bond is purchased for $110, and on redemption the taxpayer gets $100. That $10 is bond premium. Under the present law the amount of that $10 is treated as capital loss in the year in which the bond is redeemed. This proposes in the case of such a bond, the $10 of the bond premium shall be amortized over the life, the remaining life, of the bond. In the case, let us say, of a 10-year bond, the amortization would be $1 a year for 10 years.
>
> * * * * * *
>
> In the case of a bond the interest which is wholly or partially taxable, the amount of the amortizable bond premium for each year is allowed as a deduction and the basis of the bond is adjusted accordingly, so that when the bondholder at the end of the period redeems his bond, his basis will be down so that he has neither a capital gain nor capital loss.

Subsequently, Mr. O'Brien stated that the amortization sections were to be enacted (p. 53) "On the theory that the interest yield on the bond is

what he bargained for at 110, and he didn't bargain for a capital loss."

These legislative materials demonstrate that Congress' purpose in enacting section 125 was to substitute annual deductions by way of amortizing premium for the prior procedure of taking losses on the maturity or disposition of the bond. The basic premise of the new statutory provision was that the purchaser of a bond at a premium makes a capital expenditure and will in every case realize an ultimate loss. Prior to the enactment of Section 125 this loss was recognized in full at the time of disposition, and the holder was not permitted to recover the premium by deduction from the interest payments which were fully taxed as income. In other words, what the Treasury had in mind in proposing the legislation, and what Congress was concerned with in enacting it, was the situation where an individual might, for example, pay $110 for a $100 face value bond bearing a high interest rate, and callable at $100. Under such circumstances, on redemption the holder would receive $10 less than he paid for the bond;[1] and Congress—in recognition of the relationship between premium and the high interest rate (*supra*, pp. 12-18)—consid-

[1] Normally, the premium could not be wholly recovered by later sale of the obligation, since the value of the bond would decrease by the mere passage of time, as the call or maturity date approached and the premium (which depends upon the rate of interest and the period during which interest remains to be paid) diminished.

ered it sounder accounting practice to amortize the premium out of interest as a substitute for the prior procedure of taking a loss on disposition. But the necessary condition still remained that the capital expenditure which was to be recovered out of the interest earnings, through amortization, would otherwise be an inevitable loss. If the new yearly amortization deduction did not represent a portion of such a loss, it would be a pure windfall to the taxpayer, having the effect of granting a tax benefit for no valid purpose.

B. *The excess payment made by the taxpayer was not true bond premium, and he is not entitled to the deduction.* In upholding respondent's claim to an "amortizable bond premium" deduction, both of the lower courts ignored the basis for that deduction as revealed by the foregoing legislative history. The net effect of their determination is to permit the recovery of so-called "premium" out of interest (by way of the amortization deduction) although no premium was actually reflected in the interest payable on the bonds, to permit such recovery as a substitute for a nonexistent loss, and thus to sanction one of the most striking tax avoidance devices as yet propounded. For under the taxpayer's theory the excess is really not "amortizable" over the life of the bonds but is fully deductible in a single year where the bonds are callable at any time after notice, and six months later the bonds can be

sold at a long-term capital gain, the process being continuously repeated.[8]

1. In the first place, allowance of the deduction here is to run counter to the statute's aim to permit recovery out of interest payments of that portion of the payments which really represents the capital paid for a higher rate of return. In these cases, the 3% interest paid on the A. T. and T. bonds was the average rate of interest, and did not exceed the rate for comparable securities.[9] Accordingly, the interest payments would reflect only interest, and would include no premium or capital to be recovered; in Mr. Paul's phrase (*supra*, p. 16), the bonds' yield would be "true income to the taxpayer" and therefore fully subject to tax as income. Conversely, it is plain, as the courts below admitted (R. 13, 18–19), that the excess payment made by the purchaser was entirely unconnected with the interest paid on the bond. It was made for the privilege of converting the bonds to stock at below the then

[8] The record in this case does not show when or how the taxpayer disposed of the bonds in question, but the Tax Court's findings in the *Shoong* case, *supra*, show that debentures of the same issue were purchased on advice of counsel that the amount treated as bond premium could be deducted for income tax purposes and that after the bonds had been held a sufficient length of time so the gain could be reported as a capital gain they were resold. See *supra*, pp. 10–11.

[9] The *Shoong* record contains a stipulation, adopted by the Tax Court, showing, by reference to returns on comparable obligations, that the yield of the A. T. and T. debentures was not above average (No. 453, R. 27–28).

market price of the stock.[10] In short, the excess was not true bond premium; it was in no wise reflected or included in the interest rate or the interest distributions; and no reason exists to allow for the recovery out of interest of that which is not connected with, attributable to, or, in any way, reflected in the interest.

2. Still more important is that the interpretation of the Court of Appeals produces the extraordinary result of permitting the taxpayer to recover out of the bonds' interest something which has not been, and will not be, lost. As we have shown (*supra*, pp. 12–19), Congress did not intend to create, in Section 125, a special and gratuitous deduction unrelated to the taxpayer's expenditure of capital to obtain an above-average yield. The legislative purpose of the new deduction was to provide a substitute method for taking account of the fact that the amount of the premium is lost upon redemption of the bond. Previously, the bondholder could only treat this loss as a capital loss at the time of disposition or maturity; Section 125 permits the loss to be amortized and offset, as it were, against the annual interest payments. *Supra*, pp. 13–15, 18–19.

[10] See fn. 11, *infra*, p. 22. The *Shoong* findings also show that other public utility bonds of comparable investment desirability, but without comparable conversion rights, sold at a much smaller premium during this period. See No. 453, R. 26–27, 35.

But in this case there is no loss for the respondent to recover out of interest earnings. Assuming a static market, the taxpayer is always in a position to recover the excess price paid by converting the bonds into stock, or simply by selling the bonds which would continue to reflect the value of the conversion privilege." That is, respondent could at all times recover the full price he paid for the bonds (including the excess) either by exercising his option to pay an additional $40 and obtain A. T. and T. stock worth $163, or by selling the bonds at about the price he paid for them ($121). Unlike the case of the true bond premium with which Congress was

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[11] In 1945, the Commissioner found that over a substantial period of time the differential between the selling price and the call price of these A. T. and T. bonds had varied directly with the market price of the stock into which the bonds were convertible. The ruling is published in 1945 P-H, par. 76-157, and 1945 C. C. H., par. 6139, and is quoted from at length in footnote 15 of the Tax Court's opinion. (R. 12.) It states, in part, that "for nearly two years, the market price of those bonds has fluctuated almost directly in accordance with the quotations on the common stock in which such bonds are, at any time, convertible. This clearly indicates that substantially all of the so-called premium of $23.00 represents the market value of the conversion option, rather than a premium paid for the investment value of the security itself, considered independently of the conversion option" (R. 12).

The Tax Court's findings of fact in the *Shoong* case, No. 453, illustrate in detail the close relationship between changes in the value of the stock and changes in the bond prices. For about four years (1943–1947) the excess in the sale price of the stock over the sale price of the bonds was approximately $40—the additional cash required to convert the bonds into the stock. See No. 453, R. 24–25, 61.

dealing, the value of these bonds bearing the privilege to convert to capital stock at a "profit" approximately equal to the excess price would not decrease by the mere passage of time. The taxpayer is therefore always free to recover his outlay through conversion or sale—the bonds' yield is irrelevant to that recovery—and there is no reason or purpose in allowing him a deduction designed to cover the case of a bondholder who can only recover his excess payment out of the security's interest distributions. Of course, the market in fact is rarely static, but, as indicated in footnote 11, the fluctuation in the price of the bonds will vary directly with the price of the stock, and the amount which the bondholder can recover may be either more or less than his original outlay. The important thing, however, is that fluctuations in the amount recoverable are due to changes in the value of the option to convert and are in no way related to the passage of time as would be the situation in the case of true bond premium.

3. A very careful analysis of the legislative history and the rationale of the deduction set forth in Section 23 (v) and 125, in relation to the instant situation, was made by the Ninth Circuit in the *Shoong* case, No. 458, and the court there concluded that it was (177 F. 2d 131, 134; No. 453, R. 68):

> * * * obvious that the 1942 Act's embodiment of this accounting practice [of

> amortizing bond premium] is not applicable to the price above the principal of the bond attributable solely to a covenant to sell the company's stock at what may bring a profit to the purchaser.

And as the court stated, in reaching a conclusion contrary to that reached below (177 F. 2d, at 135; No. 453, R. 69–70):

> The cost of a bond above its maturity value because of a favorable interest rate was regarded as an amount expended to earn that interest, and sometimes recoverable as a capital loss. The deductions claimed in the instant case, however, represent no such expenditure to earn interest. The added amount over the maturity value of the bonds here represented the value of the stock purchasing right, which added amount had nothing to do with the call or redemption value of the bond. It earned the buyer nothing. It only brought him a stock speculation.

4. The purpose and history of the 1942 amendment thus affirmatively require that the claimed deduction be disallowed as outside the scope of the statute. Even if the matter was less clear, and the doubt greater, the balance would be swung by the established principle that deductions from gross income are matters of legislative grace, and the taxpayer bears the burden of showing that he falls squarely within the statutory class.

Deputy v. *du Pont*, 308 U. S. 488, 493; *Helvering* v. *Northwest Steel Mills*, 311 U. S. 46, 49.

C. The Court of Appeals for the Second Circuit erred in reading the statute and the legislative history. 1. The Second Circuit's brushing aside of the amendment's aim and history seems to rest largely on the view that Section 125 contains its own broad definition of "amortizable bond premium," which encompasses all excess payments over call price or maturity value. The court refers (R. 18) to Section 125 (b) (1) (Appendix, *infra*, p. 32) which provides that "the amount of bond premium * * * shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date * * *." But this provision does not contain a definition of "amortizable bond premium." As its wording indicates, it merely states the *method* of computing the amount of the premium, once it has been decided that an amortizable bond premium exists in the particular case. A statement of the method of computation of the amount of premium—assuming a real premium exists—is not helpful in the earlier step of deciding whether or not an excess payment is a true premium. Since Congress did not explicitly define "amortizable bond premium," the latter issue must be determined in accordance with the plain legislative purpose which we have set forth.

United States v. *Amer. Trucking Ass'ns,* 310 U. S. 534; *Harrison* v. *Northern Trust Co.,* 317 U. S. 476; *Mitchell* v. *Cohen,* 333 U. S. 411; *Gregory* v. *Helvering,* 293 U. S. 465; *Minnesota Tea Company* v. *Helvering,* 302 U. S. 609; *Armstrong Co.* v. *Nu-Enamel Corp.,* 305 U. S. 315, 333. Under this test, the excess payment made by respondent in this case cannot rightly be called a bond premium—any more than a bond premium would exist if one of the paragraphs attached to an evidence of indebtedness provided that the holder, having paid $20 over and above the redemption price, would be entitled to purchase gold or silver, or indeed any other commodity or security, at $20 below market price. In both instances, it is apparent that the excess payment is not bond premium but merely represents the price of what is in essence an option to buy gold or stock or some other property.

Certainly, Congress, in stating (in Section 125 (b) (1), *infra,* p. 32), the method of computing the amount of bond premium, did not intend to, and did not in fact, state that any amount paid in connection with a bond over and above the redemption price would be recoverable out of the bond interest (by way of this deduction), regardless of the nature or purpose of the excess payment, regardless of the fact that the payment was in no way reflected in the interest earnings, and regardless of the fact that the purchaser had

received value for the excess price entirely apart from the investment value of the bonds.[12]

2. The Second Circuit also relies on a supposed broader definition of bond premium in the law of trusts (R. 32). This reliance is particularly inappropriate in dealing with a tax statute directed to specific ends. In *Merchants L. & T. Co.* v. *Smietanka*, 255 U. S. 509, 521, which involved a determination as to whether the sale of corporate stock by testamentary trustees was income, this Court stated:

> The opinions of the courts in dealing with the rights of life tenants and remaindermen in gains derived from invested capital, especially in dividends paid by corporations, are of little value in determining such a question as we have here, influenced as such decisions are by the terms of the instruments creating the trusts involved and by the various rules adopted in the various jurisdictions for attaining results thought to be equitable.

[12] An analysis of the framework of the statute supports this position, and indicates the error in the Court of Appeals' reading of section 125 (b) (1). As we have shown, the purpose of the amendment was to limit the payment of the tax to the true yield or true interest and to allow for the recovery, by deduction, of the difference between the true yield and the actual rate of interest which is simply premium returned. For this reason, Section 125 (a) (2) provide that there will be no deduction where no part of the purported interest is taxable. Where no part of the distribution is taxable, there is no reason to allow for the deduction of that portion which is not true interest but is premium.

See also *United States* v. *Pelzer*, 312 U. S. 399, 402–403; *Morgan* v. *Commissioner*, 309 U. S. 78, 81.

Moreover, the general rule as to the trustee's duty to amortize, which the court cites (R. 32), does not show that a state court, faced with the striking situation presented here, would not require trustees to take account of the fact that the excess payment was plainly not true bond premium. And insofar as the court indicates its belief that a premium does not reflect a higher interest rate and that amortization should not be allowed (see R. 32, esp. fn. 1), the court was merely expressing a concept of premium deliberately repudiated by Congress in the 1942 amendment. It is significant, furthermore, that the very accounting theory as to the nature of premium, which we urge was embodied in the amendment, was propounded by the Government in *Old Colony Rd. Co.* v. *Commissioner*, 284 U. S. 552, 560–561. While the Court recognized the soundness of the theory, it concluded that Congress did not have that concept in mind in utilizing the common term "interest." Here, however, the legislative history overwhelmingly demonstrates that Congress did use the term "bond premium" in the sense for which we contend.

3. Nor is it true that the Commissioner's position "requires the making of narrow and quite possibly unfair distinctions between varying bond issues" (R. 20). The distinction is not between

bond issues, but between those extra payments which are bond premium and those which are not. A convertible bond may be purchased at a price in excess of redemption value under circumstances clearly indicating that the excess is truly bond premium and is reflected in, and thus recoverable from, interest earnings. This, however, is not the case here. As cases arise in which taxpayers claim payment of a true premium, the Tax Court, or other trier of facts, can decide in each instance whether the claim is valid or not. Decision in these cases will be no more difficult or complex than the numerous problems of fact and of apportionment which the Commissioner and the courts are daily called upon to make.

4. Finally, there is no substance in the reliance of the taxpayer, and of the courts below (R. 14, 19, 32), on a single sentence in the Committee Report, to the effect that convertible bonds are within the purview of Section 125 if the option to convert lies with the holder. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942–2 Cum. Bull. 372, 433–434).[13] Since the overriding purpose of the statute is illustrated by the abundant legislative history (*supra*, pp. 12–18), it is manifest that this sentence indicates no more than that true premium paid for convertible bonds may be amortized where the option to convert

[13] The sentence reads: "In the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of the section." (R. 14).

is with the holder. It does not amount to a statement that any payment made in excess of the call price of a convertible bond is necessarily "amortizable bond premium", within the meaning of Section 125, simply because the option to convert lies with the holder. If there is a true premium, and if the holder has the option, then the bond "is within the purview of the section", and the Report does not purport to say any more than that.

CONCLUSION

The decision of the Court of Appeals for the Second Circuit is wrong and should be reversed.

Respectfully submitted,

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APPENDIX

1. Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(v) [as added by Sec. 126 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Bond Premium Deduction.*—In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

SEC. 125 [as added by Sec. 126 of the Revenue Act of 1942, *supra*]. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.*—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.*—In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.*—In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of credit in case of interest partially tax-exempt.*—In the case of any bond the interest on which is allow-

able as a credit against net income, the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on account of amortizable bond premium, see section 113 (b) (1) (H).)

(b) *Amortizable Bond Premium.*—

(1) *Amount of bond premium.*—For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount amortizable.*—The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.*—The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on Taxable and partially Taxable Bonds.*—

(1) *Eligibility to elect and bonds with respect to which election permitted.*—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially Tax-Exempt.*—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25 (a) (1) or (2) is allowable; and

(b) *Wholly Taxable.*—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, is not allowable.

(2) *Manner and effect of election.*—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the

partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of Bond.*—As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

(26 U. S. C. 1946 ed., Sec. 125.)

2. Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.125–1. *In General.*—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

* * * * *

It is optional, at the election of the taxpayer, with respect to—

(1) fully taxable bonds (the interest on which is subject to normal tax and surtax),

whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

* * * * *

Sec. 29.125–2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of

the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125–5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

* * * * *

Amortizable bond premium on any bond to which section 125 applies in such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 29.125–3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first tax-

able year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. * * *

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125–2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) the amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

SEC. 29.125–4. *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election

shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

SEC. 29.125–5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of section 125. For the purposes of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the

bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.